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SUBJECT: PERU FORECASTS 7% GDP GROWTH FOR 2007, SHIFTS
POLICY FOCUS TO SOCIAL ISSUES

SUMMARY

1. In its latest medium-term economic report, the GOP raised its forecasted GDP growth rate for 2007 to 7.0 percent from its August 2006 forecast of 5.5 percent. This reviewed increase is in line with the Central Bank's May 2007 poll of local financial institutions and economists. The GOP report notes Peru's vigorous growth over the last six years, and its success in minimizing its vulnerability by substantially reducing the fiscal deficit and the foreign debt to GDP ratio. Responding to the nation's negligible improvement in major poverty indicators, the report attempts to re-orient the focus of Peru's economic policy goals by introducing more social indicators into its forecasts. The GOP now states that it aims to significantly improve Peru's key social indicators by the end of President Garcia's term in 2011. These indicators include total poverty, rural poverty, chronic malnutrition, and education, among others. While continued economic growth in the next few years seems likely, meeting the GOP's social goals will provide a special challenge. End Summary.

LONGEST EXPANSION CYCLE

2. In its 2008-2010 Multi-Annual Macroeconomic Framework report, released on June 2, 2007, Peru's Ministry of Economy and Finance (MEF) refers to Peru's current economic expansion as the country's longest. The report notes that expansion from the second half of 2001 through the second half of 2006 has lasted 22 quarters. This is far longer than the average 14 quarter duration Peru had previously experienced. The growth is also slightly stronger at 5.5 percent versus the average of 5.4 percent GDP increase of the 1972-1975 expansion. Peru saw a real GDP increase of 33 percent during the 2001-2005 period.

VIGOROUS GROWTH TO CONTINUE

13. The report increased the MEFQs medium-term GDP forecast for the 2007-2011 period. In August 2006, the MEF forecasted an average GDP increase of 5.2 percent in the 2007-2009 period. It now predicts GDP growth will average 7.0 percent in the 2007-2010 period, as shown in the table below. The MEF expects private investment to remain strong, with exports increasing in 2007, while inflation will stay low.

Peru Forecast: Main Macroeconomic Indicators 2006-10

	2006	2007	2008	2009	2010
- Gross Domestic Product					
Nominal GDP(bns USD)	93.5	104.0	112.2	120.9	130.9
Per Capita GDP (USD)	3,394	3,732	3,981	4,242	4,544
- Population (mln)	27.5	27.9	28.2	28.5	28.8
- Annual chg, real terms (pct)					
GDP	8.0	7.0	6.5	7.0	7.5
Private Consumption	6.5	6.0	5.0	5.2	5.2
Public Consumption	8.7	4.0	3.2	2.9	2.7
Private Fixed Invest.	20.2	15.5	12.0	12.5	12.6
Exports (volume)	0.3	8.1	8.1	8.2	11.6
Imports (volume)	12.3	14.0	11.5	11.0	10.0
Inflation (ann.avg.)	2.0	0.9	2.0	2.0	2.0
- Percent of GDP					
Fiscal Balance	2.0	0.0	-0.5	-0.5	-0.2
Current Acct Balance	2.8	1.5	0.6	-0.2	-0.4
Public Ext. Debt	23.5	20.9	18.8	17.5	15.9
- Million USD					
Exports	23,800	26,131	28,100	29,906	33,119
Imports	14,866	17,799	20,377	23,310	26,392

<http://www.mef.gob.pe/ESPEC/MMM2008underscore 2010/MMMu nderscore2008underscore2010.pdf>

14. After a far better macroeconomic performance in 2006 than expected, local observers anticipated the GOP would review and increase its 2007 and medium-term forecasts for August 2006, the first forecast of the then incoming Garcia Administration. In August 2006 the MEF had forecasted a real GDP increase of 6.6 percent in 2006 and 5.5 percent in 2007. However, 2006 brought a real GDP increase of 8.0 percent, low inflation of 2.0 percent, a fiscal surplus of 2.0 percent of GDP, and a surplus in the Balance of Payments current account of 2.8 percent of GDP.

15. The first quarter of 2007 was also strong, with a GDP increase of 7.5 percent year-on-year. This was fueled by a robust domestic demand increase of 10.2 percent year-on-year (including a private gross fixed investment increase of 19.5 percent year-on-year), which more than compensated for a weak 1.0 percent increase in exports. Inflation stayed low at 0.4 percent.

POLICY SHIFT TOWARDS SOCIAL ISSUES

16. For the first time, the government is setting poverty reduction and social goals. The 2006 election made the Garcia government painfully aware that the universal public perception is that while the economy is booming, poverty is by no means disappearing. Peru's poverty has remained stubbornly high in spite of recent years' strong, sustained growth and moderately high social expenditures by the GOP. In order to avoid potential social unrest in the not too distant future, the GOP wants to maintain continued foreign and private investment and continue business-friendly policies. But the government will also need to focus on making its anti-poverty programs more effective. Several months ago, the government announced a series of rather timid administrative measures, consolidating and streamlining a few dozen

agencies and programs.

¶17. The report highlights the GOP's aim to reduce poverty and other indicators by 2011, the final year of Garcia's presidential term. The GOP plan is to reduce overall poverty from about 50 percent to 40 percent; to cut rural poverty from about 70 percent to 50 percent; and to improve several other social variables. The table below lists some of the main goals of the GOP's social programs.

Peru: Main Social Programs Goals by 2011

- Rural poverty: To be reduced by 20 percentage points (from 72 percent currently)
- Chronic malnutrition of children under five years old in rural areas: To be reduced by ten percentage points (from 39.0 percent currently)
- Drinking water supply in rural areas: To be increased by 20 percentage points (currently 63.2 percent have no access to drinking water supply)
- Elementary education of children under six years old in rural areas: To be increased by 20 percentage points (from 41.3 percent who attend Elementary Schools currently)

POVERTY AND UNDEREMPLOYMENT

¶18. The report discusses wide ranging reforms and project changes the GOP will need to undertake in order to substantially improve the effectiveness of its poverty-fighting programs. Although the expansion

has created many jobs, particularly in the sectors of farming and apparel, poverty remains around 50 percent (the last official figure is from 2004 at 51.6 percent).

¶19. One reason explaining Peru's minimal poverty reduction is the country's high unemployment. The official unemployment rate for Lima is nominally just under 10 percent. However, the country's reality includes significant rural unemployment and a considerable "underemployed" population, including part-time vendors, taxi drivers, and household laborers. There are about 300,000 underemployed workers in Lima alone, according to the Ministry of Labor. The underemployed in Lima have gone from 56.2 percent in 2003 to 54.1 percent in 2006. To continue reducing this high level of underemployment, analysts say the economy would need to grow much faster than the 7 percent the MEF forecasts from 2007 to 2010, and sustain that growth for a longer period.

COMMENT

¶10. Continued high metal prices, stronger export and import growth through the U.S. Peru Trade Promotion Agreement (PTPA), surging domestic demand, and increased private investment are all elements that will help Peru's economy maintain the impressive growth it has seen over the past five years. But in order to improve the stubborn poverty indicators, more is needed. By introducing key social indicators as measurements of policy goals, the GOP has only formalized what most voters had realized in 2006, i.e. that the country's superb macroeconomic growth has not managed to sufficiently reduce poverty. If poverty, malnutrition and government services are to be reduced further, the government will have to tackle the issue separately through more effective government programs, better coordinated spending plans with the regions, judicious oversight of the extractive industry funds (canons), and intelligent use of the proposed Millennium Challenge Account threshold program.

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